

KEY FACTORS OF FINANCIAL STABILITY OF ENTERPRISES: CASE FROM LATVIA

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Abstract:

Financial stability is one of main characteristics of companies' performance. The analysis of statistical data shows that European companies prefer raising debt than own capital. The average level of ratio "own capital to total assets" is equal to 32.89%. This fact points at: 1) instability of companies being analyzed and 2) possibility of their insolvency risk. The aim of research is evaluation of factors influencing financial stability in order to help Latvian enterprises keep financial stability on the highest level. The main points examined in this paper are: influence of Latvian legislation on financial stability of Latvian enterprises; information as a critical factor of stability; the role of Intellectual Capital in raising financial stability; impact of outsourcing on companies' stability. Financial success is a key element not only in concrete business prosperity but also in countries' economic development.

Introduction

A distinctive feature of modern enterprises is their activity in a dynamically changing business environment. In business process, companies enter into direct and indirect relations with the contractors, customers and peers, as well as with the rest of those interested in their activity. Of course, it is difficult to protect their financial stability from negative environmental effects under such conditions. In modern scientific literature the role of factors affecting the financial stability of an enterprise (for instance, intangible assets) is underestimated, so one should make an analysis of them and work out recommendations for enterprisers in order to raise effectiveness of the management of resources to provide sustainable development.

The aim of research is evaluation of factors influencing financial stability in order to help Latvian enterprises to keep financial stability on the high level. The objects of research are the factors of financial stability of Latvian enterprises representing the real sector of economics (i.e. non-financial factors). The subject of the research is the process of rising of financial stability of an enterprise. The authors of the research used such methods as comparative approach, method of average, analytical approach, the method of financial ratios.

Statistical review of situation in Latvia

The authors of this paper examined financial statements of Latvian companies. The actual solvency ratio of enterprises (owners' equity to liabilities) had been decreasing for last years. This can cause problems with covering liabilities in nearest future.

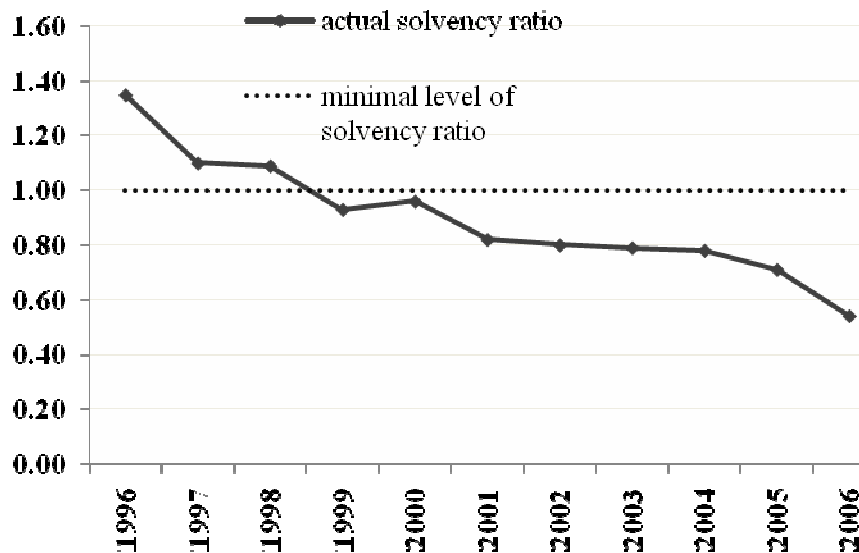


Figure 1. The trend of solvency ratio

The graph shows that starting from 1998, the level of gearing ratios is lower than a generally accepted minimum reasonable level. Despite the sufficiency of this index may vary in every company, the global tendency may lead to the negative results in a long-term perspective. Conducting an additional analysis of financial statements of Latvian enterprises, the authors compared the average level of financial stability of companies within four past years, calculated as division of long-term capital to the total value of assets, with profitability of own and overall capital. The results of the research are illustrated by graph 2.

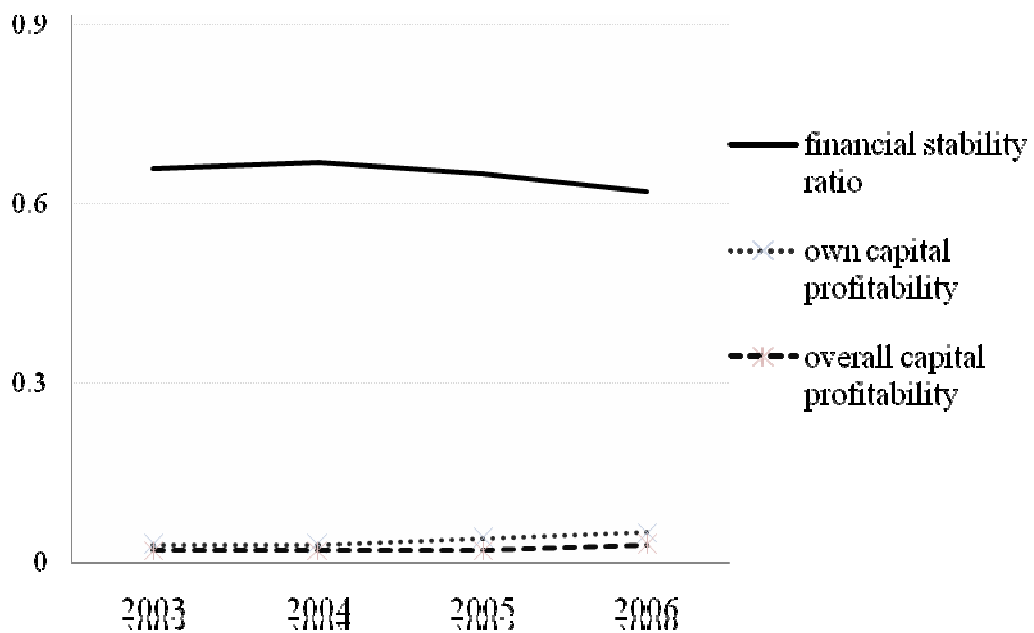


Figure 2. The tendency of financial stability ratio, own and overall capital profitability

The results show that ration of resources which an enterprise may use for its functioning for a long-term period decreases annually. But the same time, the level of own and overall capital rises and provides a more stable financial condition of a company and bespeaks a rational use of own and attracted funds in the business of an enterprise.

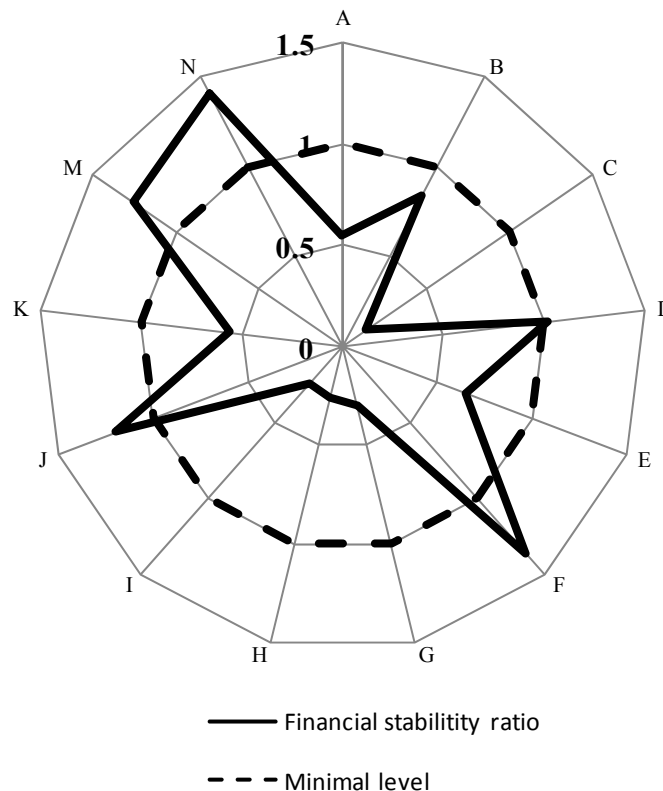


Figure 3. Solvency levels by sectors of Latvian national economy

(Symbols: A- agriculture; B – fishing; C – mining; D – manufacturing; E-electricity, gas and water supply; F – construction; G – trade; H – hotels and restaurants; I – transport and communication; J – financial intermediation; M – education; N – health services)

The lowest levels of financial stability are in such sectors of national economy like mining, operations with realty, transports and communications hotel business. More financially stable companies are running their businesses in such sectors as building industry, finance and health services. It could be depended on specific of companies business and capital profitability [1]

Latvian legislation influence on financial stability of Latvian enterprises

One of the most important external factors of the financial stability of Latvian enterprises is legislative branch. On January 1st, 2008, a law about insolvency came into operation, with an aim to balance the interests of obligors and creditors. Before that the sphere of insolvency was controlled by the law “About insolvency of enterprises and entrepreneurial societies”, which implied the maximal protection of creditor’s interests. As Latvian enterprises do not have an opportunity to solve financial problems by means

of contingency plan administration measures, the former commercial act entertain a possibility of a gratuitous bankruptcy.

Promulgation of a new act about insolvency implying two processes – the protection of creditors and obligators – can be considered as a positive factor of stability and solvency of Latvian enterprises, because it provides the following things: 1) protection of the interests of creditors, 2) a possibility to restore the solvency of an enterprise, 3) obligator supervision during the period of non-solvency, 4) the relevancy of declaration of insolvency, 5) minimal debt amount considered to be enough to admit the insolvency of an enterprise. In spite of a fact that Latvian insolvency institution is not developed, the promulgation of a new law will have a positive influence on the stability of companies.

In the context of this article the authors must mention a research completed in 2002 by World Bank Foreign Investment Advice Service and Latvian Development Agency in Latvia about the administrative barriers of business. As 98% of Latvian companies represent small and medium business, the research was covering these types of business. In the consequence of analysis the following negative factors were discovered: imperfection of taxation and customs administration, the problems in using of building permissions, administrative corruption, and shadow economy basing on the relations with officials.

Graph 4 shows business-limiting factors and their weight [2]. Percentage ratio from 0 to 10 illustrates the frequency of appearance of barrier in business; relative ratios shown by graph imply the level of their influence on the business of an enterprise rated from 1 to 4.

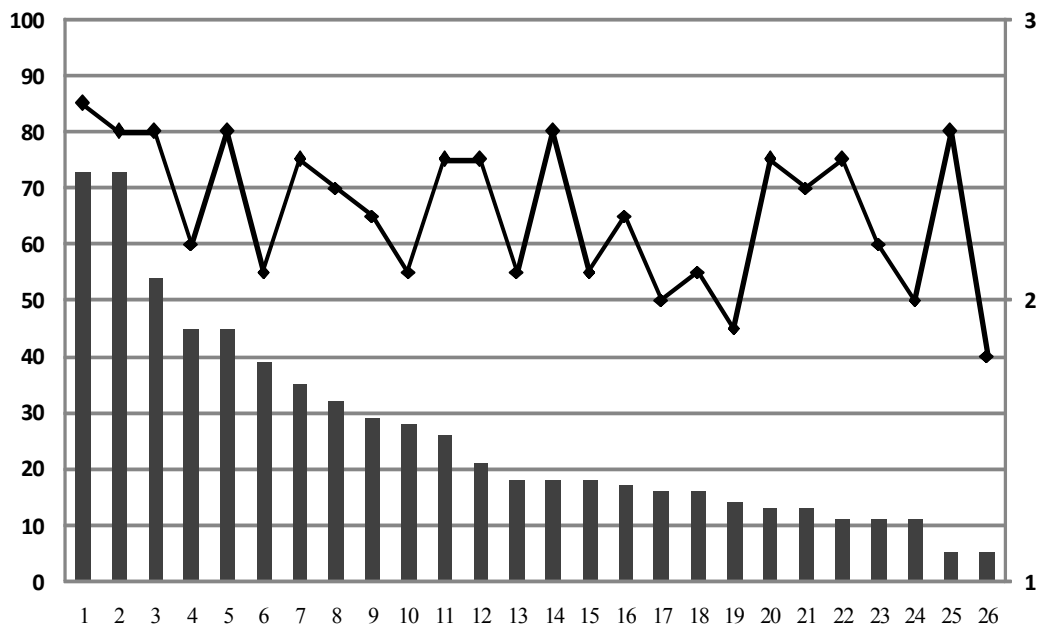


Figure 4. The administrative barriers of business

Figure 4 illustrates next factors:

1. tax rates
2. instability and unpredictability of changes in laws and regulations
3. tax regulations/administrations
4. costs of infrastructure services
5. competitions with shadow economy
6. inflation
7. corruption in public sector
8. personal and property safety
9. favouritism/cronyism
10. obtaining business licensing
11. anti-competitive practice
12. access to construction permit
13. municipal police inspections
14. access to land
15. labour legislation and regulations
16. customs legislation and regulations
17. inspections of premises
18. standards for product and service certification
19. registering process of a new business
20. functioning of the judiciary
21. access to infrastructure
22. intellectual property rights regulations
23. organized crime
24. environmental legislation and regulations
25. expatriate employment regulation
26. foreign exchange legislation and regulation

Such factors as taxation rates and instability of law constitute a serious threat for Latvian companies.

Information as a critical factor of financial stability

A great majority of factors are having an influence on the stability of an enterprise. Nevertheless, the company should pay attention to the analysis of controllable factor information [3]. Modern environment bespeaks the changes in business, as well as the changes in level of informational need of the company. Information is a resource aimed to help orientate in the conditions of market. The researches show that the manager spends 50-90% of his time on average on the search, the analysis and exchange of information [4]. Data adequacy, an ability of collecting the right information, analysis skills represents the critical factors of success in business.

Factors of success in business were classified and evaluated by numerous scientists. In 1995 Huotary identified information management as one of 8 key factors of success in the branches of pharmacy and publishing [5]. Information factor was admitted as a success factor by Estonian scientist Tibar in 2002 [6].

Stability of an enterprise can be provided by the accomplishment of the following stages of information management: 1) The definition of capabilities of an enterprise, 2) Data collection, 3) Data analysis, 4) The choice of critical success factors, 5) Critical factor analysis. Surely, the abovementioned stages are not the final ones and after the completion of all stages the company should pass to the work of arrangements meant to enhance its financial state.

The most complicated beyond the stages is the analysis of information. One should define "activity statements" that imply the aims of an enterprise. To raise the effectiveness of a company one should develop informational competency. In 2002,

Peppard suggested the following basis of informational competence of a company: Informational competence in strategy, Competence in information use opportunities [7].

Above any doubts, the information is very important in defining the critical factors of success. Here one can talk about information systems and the quality of information, even the financial data. To provide the financial stability, the company should raise the level of informational competence in such branches as: tax competence and competence in tax optimisation, resource prices, in the aspects of project success estimation, as well as in money flow management, competence in accountancy and stock bookkeeping, in price formation and profit optimisation, competence in opportunities of debt capital attraction, in the use of IT and optimisation of labour force amount and quality.

The role of IT is varies in branches and companies. The maximum attention to IT in Latvia is paid by such companies as banks and telecommunication companies. As the specialists suppose, the situation is quite different in those spheres where the companies mainly focus on the enhancement of industrial capacity, leaving the processes and resource optimisation behind. Still, IT is needed for a correct differentiation of resources, funds and the execution of orders [8].

The role of intellectual capital in the financial stability of an enterprise and the problems of its estimation

The modern literature offers the understanding of intellectual capital as the synergy of intellectual assets including:

1. market assets (intangible assets dealing with market operations);
2. intellectual property as an asset (patents, copyright, trademarks, know-how);
3. human assets (the synergy of collective knowledge of the employees and their creative skills, skills of solving problems, their leader qualities, business and management skills, as well as psychometric data and information about the behaviour of individuals in particular situations); [9]

Intellectual capital is one of production factors of companies. It affects the ability of enterprise to increase or decrease its profit, and, consequently, affects the level of stability on the whole. Modern interpretation of intangible production factors of a new value of a company are described by the term of “intellectual capital”. Some researchers presume that accounting of intellectual capital requires a new financial and management system. At the same time, the financial specialists debate about the opportunity of new index cost estimation, its accounting and reporting.

Every model has an own way intellectual capital element choice interpretation and the relations between them. The structure of intellectual capital is shown by one of the most common models «Skandia Value Scheme», developed by L. Edvinsson for a Swedish insurance company Skandia (Fig. 5). In 1995, this company was the first to include a unit about intellectual capital in its annual account and laid foundation for a new way of keeping annual accounts.

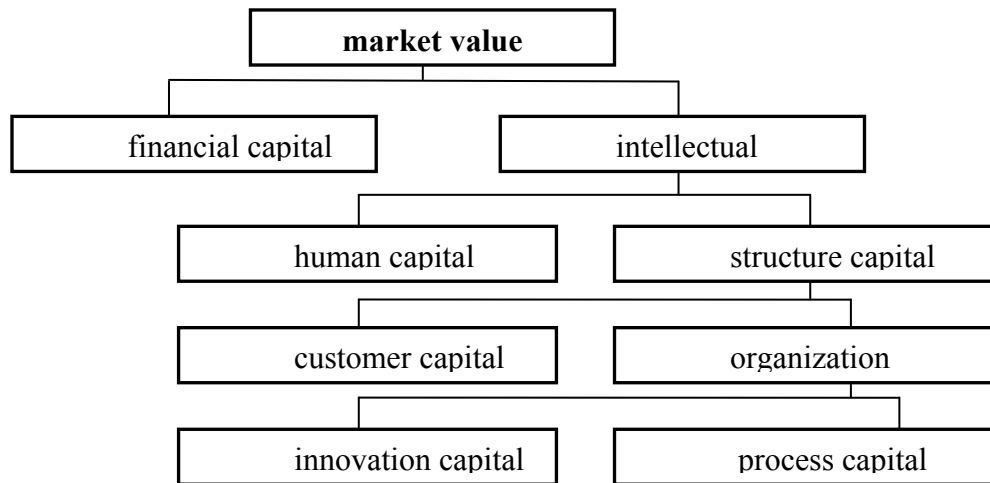


Figure 5. Intellectual capital structure in “Skandia Value Scheme” by L. Edvinsson

In the given scheme a human capital is interpreted as the skills and the competence of company’s personnel. This part of intellectual capital leaves the company together with the employees after the office hours. The structural capital is divided on client and organization capital. Client capital consists of innovation and process capital. Innovation capital features the legal rights (patents, licenses), as well as the things that can hardly be described but which largely define the value of the company (ideas, trademarks). Process capital is an infrastructure of the company (IT, operational process, etc.) In this model the intellectual capital is described as a sum of its elements [10]. Therewith, due to the complexity of the observed effects one should consider the synergy of elements ad their unequal roles in forming the value of the company. Such an attempt was made by another Swedish researcher – K.-E. Swayby. His model is very common. The following matrix describes possible indexes that characterize the level of intellectual capital that can be used in innovation growth and business efficiency estimation:

Table 1. Swayby matrix

	Competence of employees	Inner structure	Outer structure
Growth and innovations	Service record (years) Education Expenses on education of employees Inner personnel turnover Customers rising competence	Investments in IT Customers enhancing the structure	Profit per customer Customer amount growth Customers enhancing the image of the company
Effectiveness	Specialists’ part Added value per employee Profit per employee Profit per specialist	Operating crew part Index “value/personnel attitude”	Customer satisfaction index Sales per customer Index “gained/lost”
Stability	Specialist turnover wages Average Average service record	Organization life Staff turnover New employees’ part	Large client part Structure of clients based on the duration of partnership The frequency of repeated orders.

The basic structure of intellectual capital is constantly supplemented by the new approaches and attempts to consider non-financial factors of value growth and the stability of the company.

The research of the problem of intellectual capital from the point of view of the global changes in world economy, the appearance of “knowledge economy”, knowledge management in hi-tech science-driven companies, as a rule, leads to the conclusion

about the fundamental coincidence of the notion of the intellectual capital and intangible assets. F.M. Ferson and S. Pike offer the scheme of a typical interpretation of the intellectual capital.

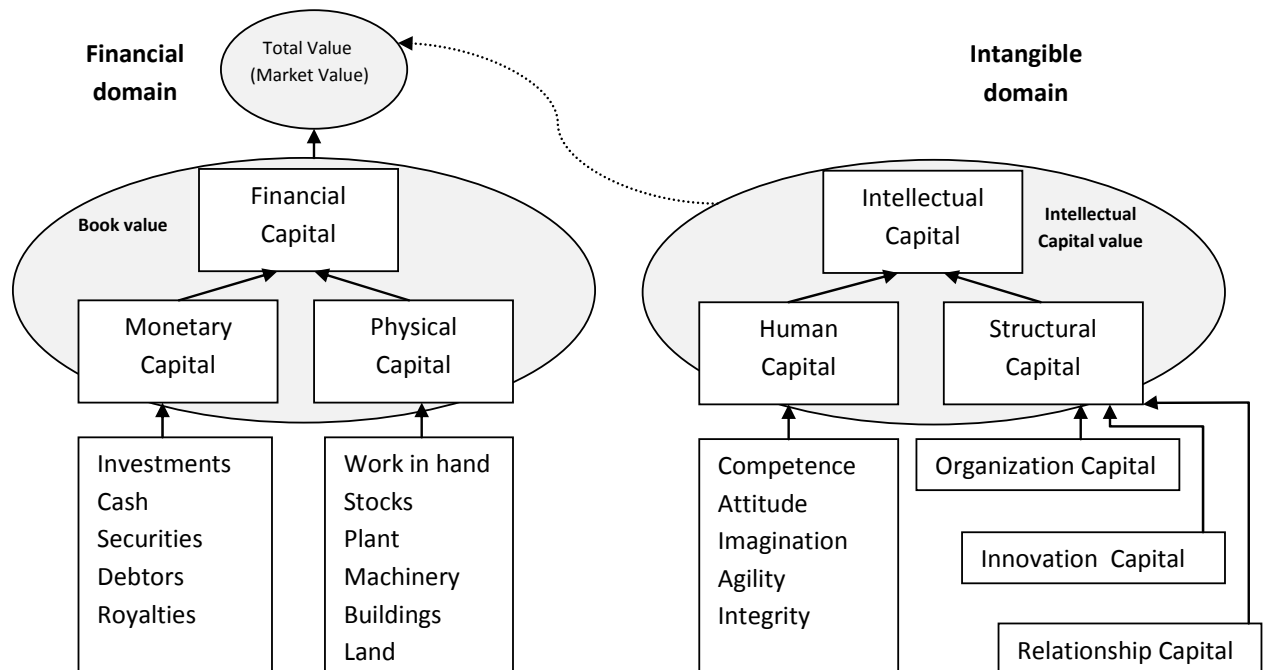


Figure 6. The organization and its internal/external activities [11]

Intellectual capital was first proposed by John Kenneth Glabraith trying to bridge the gap between a company's book value and its market value. With the tremendous growth of service industry in major industrialized countries more and more researchers have recommended that non-traditional or intangible assets of business operations such as customer relations, skills of their employees, innovations and leaderships tend to be the major determinants of a company's competitiveness and financial stability. The first author who tested intellectual capital in bankruptcy predictions was Tian-Shyun Lee, who build the model solely using the such financial ratios as profitability, financial leverage, turnover ratios, considering both – financial ratios and intellectual capital variables as independent variables. He had analysed the next ratios of intellectual capital: 1) number of employees with graduated degree division by number of employees; 2) average seniority of employee; 3) average age of employee; 4) accounts receivable of related party division by sales to related party; 5) auditors witching times; 6) financial forecasts adjusting times; 7) salary expenses division by sales; 8) fixed assets division by number of employees. The author of this model had find out the relative importance of these independent variables. The influence of different variables in different time lags to the status of company may not be the same. For verifying the feasibility on this proposed two stage hybrid approach, bankruptcy prediction tasks are performed using the public companies filing bankruptcy between 1998 and 2000 in Taiwan.

The research finding can be summarized as follows - intellectual capital does provide valuable information other than financial ratios in bankruptcy predictions [12].

Outsourcing affect on company stability

Increasing numbers of businesses are choosing to outsource their development overseas, for either smaller, defined projects or through a long-term outsourcing partnership model. The main reasons cited for outsourcing include a desire to increase company productivity and efficiency, while simultaneously lowering operating costs in an increasingly competitive economy. But with outsourcing, whether overseas or locally, comes risks. Five major risks of outsourcing have been identified in recent years: 1) Communication/cultural barriers 2) Misunderstanding of requirements 3) Quality assurance 4) Concerns about intellectual property security 5) Differences in company infrastructure and processes [13]. Outsourcing has become not only one of the most widely discussed business phenomena, but also one of the most poorly understood. One particularly viable area within business process outsourcing is finance and accounting—transferring to service provider activities such as transaction processing, general accounting and treasury. Every year, more companies outsource these activities. The reason, not surprisingly, is the pursuit of high performance: Accenture research has shown a 74 percent correlation between “finance mastery” and a high performance business. In the course of a research completed by company Accenture about the level of use of outsourcing and the affecting factors, enterprises of various branches and countries were analyzed. 36% of the companies operate in the market of Latin America, 27% - Europe and 27% - Asia. In fact, 89 percent of respondents stated that a commitment to deliver continuous improvement in finance and accounting processes is important. Another clear imperative is accessing the benefits of new technology. Respondents strongly believe that outsourcing may be the best way to obtain the benefits of leading-edge technology. This was evidenced in several ways. For example, only a third of the survey population currently use what they consider to be the best available tools to manage accounting and finance. Accenture’s ongoing research shows that high-performance businesses possess several key traits. One of these is the ability to achieve business function mastery through continuous innovation in strategic core competencies. The research found that the correlation between finance mastery and high performance is greater than 70 percent. These companies referred to as “masters of finance”— use the function in a distinctive manner to drive differentiation and superior results.

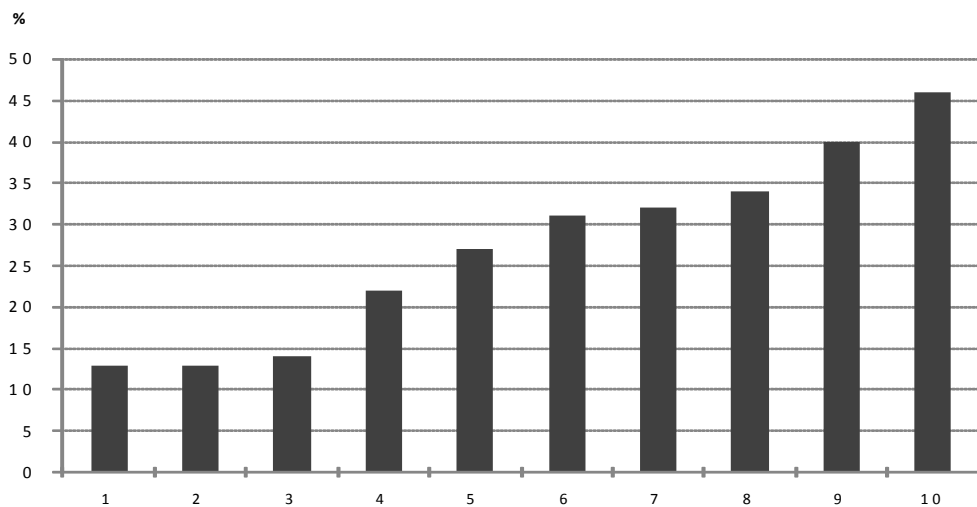


Figure 8. The methods of improving the performance of finance and accounting function in outsourcing [14]

Figure 8 illustrates next methods of improving of performance:

1. integrating multiple ERP solutions
2. improving information flow
3. delivering better performance metrics for outsources processes
4. provide strategic advice on how to grow the business
5. infusing new ideas, innovations, continuous improvement initiatives
6. enabling senior management to make better decisions
7. providing technology infrastructure
8. adopting best practices from own and other industries
9. providing more accurate and timely financial reporting
10. improving service quality

The primary reason to outsource their data centers functions is in 44% cases to reduce or control costs. The motivation for outsourcing doesn't end there. A solid third of respondents also said they do it to gain access to IT resources – people, processes, equipment. Some organizations outsource to free internal resources or improve business or customer focus [15].

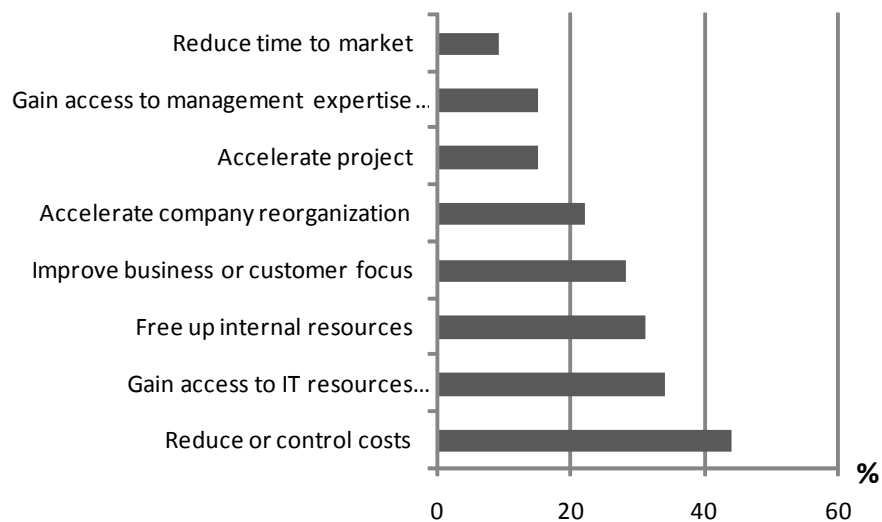


Figure 9. Outsourcing reasons

The globalisation of services will continue, reaching beyond the information technologies core that has defined outsourcing for the past decade. More companies have outsourced human resources management processes, finance and accounting, and, of late, legal services, product development and trainings. Outsourcing is one of company's financials stability factors, which can influence positively and negatively as well enterprises performance. The application of outsourcing in business may affect the financial stability of an enterprise ambiguously. Releasing more turnover resources by sparing the basic sources, the enterprise gains an opportunity to raise the turnover of the capital and enhance the effectiveness of its use under a condition that the level of intellectual capital is enough for a rational distribution of operating assets. Under such condition ever low indexes of financial stability do not imply a low effectiveness of its functioning. But if the level of intellectual capital is not insufficient, the application of outsourcing will inevitably lead to losses, non-effective use of debt and own capital, a need of attraction of additional operating assets from outer sources, and, as a consequence, to the loss of financial stability of a company.

Classification of factors of financial stability

After completing the analysis of statistical information and modern literature, the authors of this article defined the factors of financial stability of Latvian enterprises as well as their influence on the functioning of the companies.

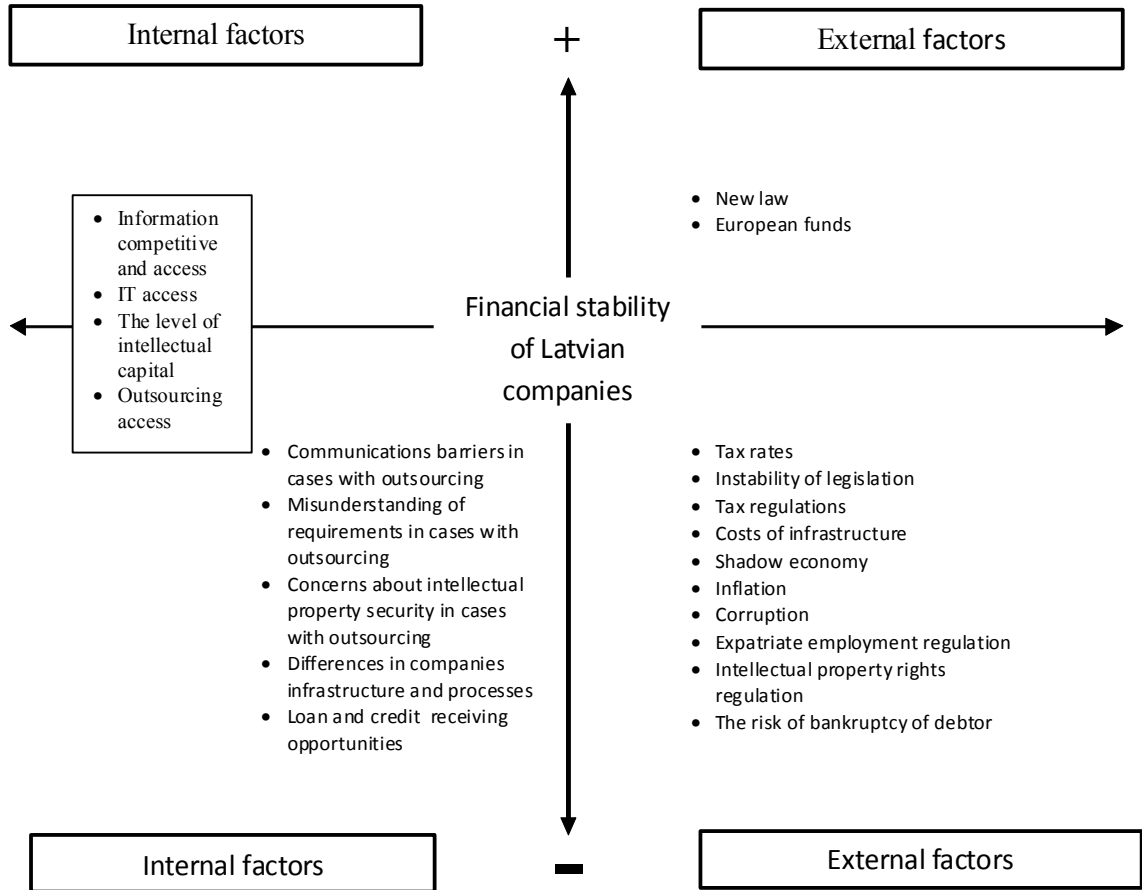


Figure 10. Factors of financial stability

The research of stability-affecting factors led to a conclusion that the vast majority of inner factors illustrate the term of intellectual capital. Control, estimation and supervision of the level of intellectual capital are the key of success in enhancing the stability and solvency of an enterprise.

Conclusion

The research in the branch of the article theme showed that the role of intellectual capital is very significant in estimation and enhancement of financial stability of the company. Modern literature focuses on this item in the context of defining the financial stability of an enterprise quite rarely. However, this is a wide field for further researches and estimation model development to predict the level of financial stability and solvency of the enterprise.

Intellectual capital has drawn serious attention from companies that derive their profits from non-traditional or intangible assets such as customer relations, skills of their employees, innovations and knowledge-incentive services. Investments in building or strengthening the intellectual capital contents should be good directions in improving

the core competence, financial stability of company. As the 21 century is the century of knowledge economics, intellectual capital is definitely going to play an even more important role for companies achieving continuous growth. Getting the companies to operate well is critical to success of entrepreneurship. It is a key element not only in concrete business prosperity but also in countries' economic development.

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